

TECHNICAL NOTE 0873

# **Registration and Taxation of Private Healthcare Practices in Kazakhstan**

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# **Issues of Registration and Taxation of Private Healthcare Practices in the Republic of Kazakhstan**

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## EXECUTIVE SUMMARY

From 21 May to 10 June 1997 consultants from USAID/Abt Associates conducted an investigation of issues of registration and taxation of private family group practices in order to provide them with knowledge which would enable them to take an informed decision to establish themselves as not-for-profit or for-profit organizations.

### Main Findings

- Private medical practices registered as private entrepreneurs (sole proprietors) or commercial organizations do not have the legal status of not-for-profit organizations, according to the Ministry of Justice's Departments of Registration of Juridical Persons;
- Under the guidelines of the National Tax Committee, local tax authorities cannot treat physical or juridical purpose for tax purposes differently from their registration status with the Ministry of Justice. Thus, if an organization is registered as a for-profit one, the tax authorities cannot treat it as a not-for-profit one for tax purposes;
- Under the current tax regulations, for-profit and not-for-profit private medical practices paid exclusively through the Mandatory Health Insurance Fund and/or the state budget receive almost identical tax treatment;
- Some private medical entrepreneurs apply their own interpretation of existing laws regulating legal status and taxation instead of using professional legal advice to minimize the risk of negative implications due to a wrong legal interpretation.

### Recommendations

- Medical practitioners applying their own interpretation to laws regulating legal status and tax treatment should also seek the opinion of a legal professional, experts of National or Oblast Departments of the Ministry of Justice, and the tax authorities to ensure themselves against potentially costly misinterpretations;
- Medical practitioners should resort to expert legal advice or seek official interpretation from the Ministry of Justice when taking important decisions on issues regulated by vague or controversial legal provisions.

### Key Definitions

*Entrepreneurial activity* is the "initiative activity of physical and juridical persons, irrespective of the type of ownership, which purpose is to produce profits or personal income through satisfying the demand for goods or services." (art. 10 (1) of the Civil Code (CC))

*Income from Entrepreneurial Activity* is "the income from sale of products (goods and services); income from sale of buildings, equipment, and assets not subject to depreciation with adjustment of price for inflation; income from activities other than sales, including income from interest, dividends, winnings, donated property and money, rent proceeds, royalties, subsidies to juridical persons other than subsidies from the state budget, income received in consideration for commitment to limit

entrepreneurial activity or close down an enterprise, income from lowering the amount of reserve funds of bank and insurance organizations, income from write-offs of bad debts, amounts included in the income according to art. 20 (7) of the Tax Code (TC), expenses subject to compensation under the provision of art. 44 of the TC.” (art. 11 TC)

## **I. Introduction**

This report discusses issues pertaining to the choice of legal format for a private medical organization, for-profit versus not-for-profit, and the tax implications of this choice. The continuing process of privatization of healthcare facilities induces potential bidders on privatization tenders and other entrepreneurs to investigate in advance the optimal juridical format for their activity corresponding to their personal (organizational) goals and providing them with the optimal tax payer status. Many of these potential bidders are medical professionals currently working for state owned clinics receiving technical assistance from USAID/*ZdravReform* Project. This report is intended to provide them with the type of information which would facilitate their search for a balance between legal status and tax treatment. The report is based on a study of key laws, consultations with lawyers, tax and accounting experts, and interviews with medical practitioners.

## **II. Factors Influencing the Choice of Legal Format for Medical Activity**

The issue of what juridical format should be chosen for the registration of a private medical practice depends on three main factors, namely, the goal of the organization, the liability of shareholders/founders to creditors, and taxation. Each of these factors and their implications on private practices are discussed in the next three sections.

### **1. The Goal of the Organization**

Under the law of Kazakhstan, an organization can either serve the commercial interests of its owner(s) by bringing them profits (for-profit organization, Rus. *Comercheskie organizacii*) or serve the interests of the whole society or a group of individuals without having a for-profit activity as its main goal (not-for-profit organization, Rus. *Necomercheskie organizacii*).

#### **A. Not-for-Profit Organizations**

Art. 34 of the CC defines a not-for-profit organization as one for which profitability is not the main goal and whose profits are not distributed among its owners. Indeed, a for-profit activity (hereinafter, entrepreneurial activity) can be a complementary goal of the organization but only to the extent it is provided for by its charter (Rus. *ustav*) (art. 34 (3) CC). Thus, a clinic registered as a not-for-profit organization but having profits from entrepreneurial activity must use them to support its not-for-profit activity, rather than distribute them among its owners.

A not-for-profit organization can be registered as an institution (*uchrezhdenie*), social association (*obshtestvennoe obedinenie*), consumer cooperative (*potrebitelskii kooperativ*), social fund (*obshtestvenii fond*), or religious association (*religioznoe obedinenie*). Articles 105-110 CC, which define the different types of not-for-profit organizations, indicate that registering as an institution (art. 105) would be the best choice of legal format for a not-for-profit private medical practice.

## **B. For-Profit Organizations**

For-profit organizations can be registered in either of the following formats: a sole proprietorship under art. 19 of the CC and the law “On Protection and Support of Private Entrepreneurship”, as a company under the law “On Commercial Entities”, or as a production cooperative under the presidential edict “On Production Cooperatives” (hereinafter, the term commercial entity or company is used to indicate both companies and production cooperatives). The main difference between a company and a sole proprietor is that the latter is a physical person entitled to carry out entrepreneurial activity whereas companies are juridical persons. (The sole proprietor is classified as an organization here for the sole purpose of clearly differentiating further between the opportunities to carry out an activity on a not-for-profit and for-profit basis).

## **C. The Issue of Not-for-Profit Tax Treatment of Commercial Organizations**

The experience of *ZdravReform* in some oblasts of Kazakhstan indicates that there is a great deal of confusion among current and potential private medical practitioners about the possibility for a for-profit organization to be treated as a not-for-profit one for tax purposes. For instance, in one oblast, several medical practitioners registered as sole proprietors are currently treated by the local tax authorities as not-for-profit organizations. Other entrepreneurs are also interested in learning more about how they can qualify for such a status, especially since the law *per se* does not entitle a for-profit organization to not-for-profit tax treatment. There are two intertwining sources of confusion demanding a further discussion, namely, unclear provisions of the CC relating to possible additional registration formats for not-for-profit organizations (other than those listed in paragraph A above) and the not-for-profit nature of medical activities carried out by for-profit organizations. The following presents a discussion on the confusing issues with the help of opposing arguments. The opinion of representatives of the Ministry of Justice and the National Tax Committee is used as a conclusion to the discussion to indicate the likely outcome of an official interpretation of the confusing issues.

Art. 34 (3) of the CC provides that a not-for-profit organization can be established in “any other format provided by law.” The interpretation of this general provision is important to determine whether sole proprietors or even commercial organizations could be treated as not-for-profit organizations. There are two possible interpretations of the provision of art. 34 (3) CC. The first interpretation which is broader is that a not-for-profit organization can be established in any legal format, including but not limited to those listed in the above paragraph. The second and narrow interpretation is that “any other format” means a format specially provided by a law or governmental decree entitling organizations to be registered as not-for-profit ones in formats different from those listed in paragraph A. The rest of this section offers a discussion

on the issue of whether a company (commercial organization) or sole proprietorship could be a not-for-profit organization.

*a) Whether a sole proprietor can be a not-for-profit organization*

The tax authorities in some oblasts treat medical practitioners registered as sole proprietors as not-for-profit organizations. The fact that there is no evidence of the reasoning used by the tax authorities to grant this status and the points of the further discussion suggest that such treatment may not be embraced by the tax authorities in all oblasts of Kazakhstan. Each of the following two arguments for and against a not-for-profit status has a merit which, again, may or may not be shared by all oblast tax authorities. A medical practitioner, however, should keep in mind that he/she is entitled to challenge tax authorities' decisions in court.

Argument 1. The sole proprietorship cannot be a not-for-profit organization.

The term not-for-profit organization is used only in relation with juridical persons (art. 34 of the CC). A not-for-profit organization can exercise entrepreneurial activity providing that it is in accordance with its goals as provided by its charter. However, the sole proprietorship by law does not have a charter. Furthermore, according to the definition of entrepreneurial activity, "the sole goal of private entrepreneurship is to receive profits (when organization) or personal income (when sole proprietor) through satisfying demand for goods or services." The sole proprietor registers as an individual entrepreneur under the laws of Kazakhstan which by definition means that his/her sole goal is to obtain personal income through satisfying certain demand. Thus, it is not the activity which defines the for-profit or not-for-profit status of the entrepreneur but the registration format. Finally, the very term "organization" implies an entity which is different from an individual.

Argument 2. The sole proprietorship can be a not-for-profit organization.

The CC provides that the regulations which apply to juridical persons registered as commercial organizations apply also to the activity of physical persons (sole proprietors) registered as entrepreneurs, unless otherwise provided by law or the nature of legal relations. Since the nature of the legal relations of medical practitioners with the Mandatory Health Insurance Fund (MHIF) is a not-for-profit one, a sole proprietor medical practitioner is entitled to a treatment as a not-for-profit organization. It is important to note, that these arguments were sufficient to convince the tax authorities in some oblasts of Kazakhstan to treat medical practitioners registered as sole proprietors as not-for-profit organizations.

*b) Whether a juridical person registered under the law "On Commercial Entities" can be a not-for-profit organization*

Such an organization cannot be a not-for-profit one. Art. 1 of this law defines a commercial entity as one whose main goal is to produce profits. However, producing profits cannot be the main goal of a not-for-profit organization under the provision of art. 34 (1) CC.

Nonetheless, the tax authorities in one oblast of Kazakhstan treat as a not-for-profit organization a medical practice registered as a commercial entity. Such a treatment

could well be based on the above mentioned broad interpretation of the provision of art. 34 (3) CC that any legal entity can be a not-for-profit organization. Yet another line of reasoning, which may also have contributed to the granting of such treatment, is that to the extent the commercial entity does not realize income from entrepreneurial activity (see key definitions above), it could be treated as a not-for-profit organization. The same argument might have been used to justify the granting of a not-for-profit tax status to sole proprietors.

*The Position of the Department on Registration of Juridical Persons at the Ministry of Justice on whether a sole proprietor or commercial entity could be not-for-profit organizations*

The Ministry of Justice's Department on Registration of Juridical Persons applies the narrow interpretation of which legal entities could be treated as not-for-profit organizations. According to representatives of this department: a) no law or governmental decree currently provides for an exception to the legal formats for not-for-profit organizations listed in art. 34 (3) and b) if the intention of the legislators was indeed to leave in the CC the possibility for an entity, whose main goal by definition is entrepreneurial (art. 19 CC), to be a not-for-profit one, this would have been specifically provided by the CC itself. In addition, it is important to note that, according to Mr. Bigali Tleulesov, head of the Department of Tax Legislation at the National Tax Committee, all tax authorities in Kazakhstan are required to treat for tax purposes organizations and sole proprietors the same way the latter are treated by the Ministry of Justice.

A physical or juridical person could request the Ministry of Justice's Department on Legislation and Registration of Regulations of State Bodies (Department Zakonodatelstva I Registratsia Vedomstvenih Normativnih Aktov) to issue an official interpretation of ambiguous legal provisions. Given the fact that some medical practitioners, supported by *ZdravReform* and registered as individual entrepreneurs, have already been treated as not-for-profit organizations by the tax authorities, it would be inappropriate for our project to make a request for an official interpretation which, given the opinion of the Ministry of Justice's Department on Registration of Juridical Persons, is more likely than not to be detrimental to the interests of these entrepreneurs.

Based on the narrow interpretation of art. 34 (3) CC, one can apply the following series of objective tests to determine whether an organization is a not-for-profit one:

Test 1 Is the organization registered as a juridical person under one of the legal formats provided by art. 34 (3) CC;

Test 2 Is the main activity of the organization, according to its charter, not entrepreneurial;

Test 3 Are the profits produced through an entrepreneurial activity used to support the main not-for-profit goal of the organization without being distributed among the founders.

If the answer is yes to all three test questions, the organization is a not-for-profit one.

## **2. Liability of the organization**

The issue of liability should be carefully considered by medical professionals intending to start their private practice. The shareholders/owners of a for-profit organization registered under the law “On Commercial Entities” in almost all cases will be liable to the creditors of their organization up to the amount of their interest in it. Thus, if the organization is liquidated, the creditors can satisfy themselves only from the property of the organization and cannot reach beyond it to the personal property of its shareholders (owners). When registered as an individual entrepreneur or not-for-profit organization (institution), the sole proprietor/founders’ liability is unlimited (art. 20 and art.207(3) CC). Thus, in case of bankruptcy of a sole proprietor, creditors are entitled to satisfy their claims from his/her personal property. Only slightly lower is the liability of the founders of a not-for-profit organization. In case of bankruptcy of a not-for-profit organization, the creditors can submit claims on the personal property of the founders when the organization’s property is insufficient to satisfy their claims.

## **3. Taxation**

The following offers a discussion on the tax implications of the not-for-profit and for-profit status.

It should be noted first that some medical professionals planning to open their private practices would like to register as not-for-profit organizations for the sole purpose of taking advantage of the favorable tax treatment of such organizations. However, logic dictates that the goal of an organization should be defined first and then its legal and taxation status will have to be brought in line with this goal, but not vice-versa.

The following table can be used as a tool for a comparison between and analysis of the tax treatment of a for-profit or not-for-profit medical practice with respect to the five main taxes in Kazakhstan.

Table 1

Type of Tax	For-profit		Not-for-profit
Income Tax	Sole Proprietor	Commercial Organization	Exempt from income not coming from entrepreneurial activity (art. 34 (1) p. 3 TC in relation to art. 11 TC). Income from entrepreneurial activity is taxed the same way as that of a for-profit organization.
	Paid on the combined income from the salary of the entrepreneur and the income produced from his/her business. The effective tax rate could be up to 40% (art. 29 TC). <sup>1</sup>	Paid on the pretax income at fixed 30% rate (20% for juridical persons registered and operating in special economic zones) (art. 30 TC). Dividends are taxed at 15% rate (art 31 TC).	
Value Added Tax	Paid on the added value portion of the prices of goods or services. Flat tax rate of 20% (art. 66 TC).		Exempt from tax (art. 61 (1) p. 5 TC).
Property Tax	Paid on fixed assets (Rus. osnovnie proizvodstvennie I neproizvodstvennie fondi) at a variable rate provided by art. 133 TC.		Exempt from tax on property not used in entrepreneurial activities (art. 134 TC). Property used in entrepreneurial activity is taxed the same way as that of a for-profit organization.
Land Tax	Paid on non-agricultural land at a variable rate (see art. 112 and 114 of the TC.) unless the medical practice is a children's health facility which is exempt from this tax (art. 123 (3) p.1).		Same as for for-profit organizations.
Tax on Vehicles	Paid on vehicles registered with the state on which the entrepreneur has one of the rights listed in art. 126 TC.		Exempt from tax on vehicles not used in entrepreneurial activities (art.120 (8) TC). Vehicles used in entrepreneurial activities are taxed at the same rate as that for for-profit organizations.

It could be seen from Table 1 that if the medical organization is established as a not-for profit one, it will be generally exempt from taxes. However, it will not be exempt

<sup>1</sup> The TC does not make a distinction between income from salary and income from the entrepreneurial activity of the sole proprietor. For instance, a medical practitioner sole proprietor can draw a salary for his work as a doctor in his/her practice. At the same time, he/she is entitled to receive the profits from his business. However, for tax purposes there is no difference between the two types of incomes and they are treated as single one--income of a physical person under the provisions of art. 29 TC.

from taxes on income from its entrepreneurial activities or taxes on property and vehicles used in this activity. This raises the important issue of how important the registration status is for medical practices which work exclusively with the MHIF, like those practices currently receiving technical assistance from ZdravReform. According to Mr. Bigali Tleulesov, head of the Department of Tax Legislation at the National Tax Committee, the income from the MHIF constitutes a form of a subsidy coming to the practices from the state budget and therefore is not subject to income tax under the provision of art. 11 (3) TC. As far as payment of VAT is concerned, work performed under a contract with the MHIF does not amount to a sale of services, in which case there is no turnover subject to VAT (the payment from the MHIF could also be interpreted as a form of compensation expenses which are also not subject to VAT). The other three types of taxes, although not subject to exemptions similar to those on VAT and income tax, are relatively small and currently paid by medical practitioners without difficulty. **Finally, the conclusion which could be drawn from the discussion on tax issues is that it is of marginal importance how the medical practice is registered, as long as it works exclusively with the MHIF or receives payments from the state budget.**

Another issue which raises valid concerns is what tax implications could be faced when a for-profit or not-for-profit medical organization working mainly with the MHIF or the state budget also collects fees from patients for certain services. In this case the only difference in the taxation of these fees between the two types of organizations will be the VAT. The fees collected by a not-for-profit organization, as shown on table 1, will be exempt from this tax while those collected by a for-profit organization will be subject to VAT.

The main benefit to a not-for profit organization from its tax status is that it can reinvest the realized tax savings back to its activities. However, unlike the owners of a commercial entity, the founders of a not-for-profit organization cannot take dividends from the profits of their organization. Most certainly, the founders can work for their not-for-profit organization and take out higher salaries which however will be subject to taxes of up to 40 percent compared to the 30 percent corporate tax. These and other issues are discussed in more detail below.

### **III. Options which Could be Considered when Deciding How to Register**

#### **Option 1: Start as a not-for-profit organization and later re-register as a for-profit one.**

The tax code of Kazakhstan still does not penalize such a move. However, one should keep in mind that more amendments to the TC are coming and it is possible that a new rule may abolish this opportunity.

#### **Option 2: Register as a not-for-profit organization and collect high salaries.**

In the United States and other countries extremely high salaries in not-for-profit organizations could be treated as abuse of the not-for-profit status. However, the TC of Kazakhstan does not provide for such salary tests. Even if such a test were available, the current broad differences in salaries in Kazakhstan would have made it extremely

difficult to provide an objective determination of excessive salary. In addition, one could make the argument that it is more advantageous to take a higher salary from a not-for-profit entity, than pay taxes on profits and dividends when a for-profit entity. The corporate tax rate of 30 percent and the tax rate on dividends of 15 percent make the total corporate tax + dividend tax = 45 percent. Compared to taxes on income of physical persons, which could be up to 40 percent, it is clear that there is still a 5 percent gain to be realized from high salaries. One should keep an eye, however, on the changing tax legislation for a TC guideline on the issue of excessive salaries in not-for-profit organizations.

**Option 3: Be an investor in the not-for-profit organization by lending money to it.**

Investors can receive interest on their loans extended to any organization, including a not-for-profit one, of up to 50 percent above the rate of refinancing set by the National Bank of Kazakhstan (art. 16 TC). The profit that the investors make on their investment, however, will be taxable.

#### **IV. Conclusion**

Although there is no 100 percent clarity on whether an individual entrepreneur or commercial entity is entitled to treatment as a not-for-profit organization, it is more likely than not that an official interpretation by the Ministry of Justice will rule such a treatment void. It is possible that the tax authorities in some oblasts, due to lack of necessary level of professional training, give advice and take positions inconsistent with official guidelines. Such positions are unstable and could be easily changed to the detriment of the medical practice. In case of a change, the only recourse to the medical practice would be to bring the case to the court which could prove to be expensive and time consuming. Therefore, medical practitioners should not rely only on the opinion of one state body, but also should seek the advice of practicing legal professionals and consult with the relevant departments of the Ministry of Justice.

Medical practitioners should consider all pros and cons of a for-profit or not-for-profit status and pick the one which would best serve their goals as each status has advantages and disadvantages and it is impossible to determine which one is better without considering the true intentions of the founder(s). Thus, generally, a for-profit status would serve better a medical practice whose founder(s) would like to keep all profits for him/herself while those who would like to use the profits for the benefit of society and reinvest them in the practice or use them generally for not-for-profit activities should consider a not-for-profit status. Finally, it is very important to keep in mind that the legal status differences are relatively small for a medical practice receiving revenues exclusively thorough the MHIF and the state budget.